No. 10784-10785

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

UNITED STATES OF AMERICA,

Appellant,

vs.

CONSOLIDATED ROCK PRODUCTS CO., a Corporation; UNION ROCK COMPANY, a Corporation, and CONSUMERS ROCK & GRAVEL COMPANY, INC., a Corporation,

Appellees.

Upon Appeal from the District Court of the United States for the Southern District of California,

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BRIEF FOR THE UNITED STATES.

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Appellees.

BRIEF FOR THE UNITED STATES.

Opinion Below.

The District Court did not render an opinion in this case;[1] its memorandum of conclusions will be found at pages 262-264 of the Record.

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[1]The court rendered an oral opinion [R. 301-319] relating to another issue concerned in the determination of the taxpayer's 1938 income tax liability. That opinion is of no moment here, except that by reason of the issue involved, the court entered judgment [R. 330-333] in favor of the United States for the sum of $441.17 as additional income tax due for the year 1938.

Jurisdiction.

This appeal involves an income tax deficiency assessment for the calendar year 1938 in the amount of $25,112.72 and interest thereon [R. 334], claimed against the appellee, Consolidated Rock Products Company, which at all times here important to jurisdiction was the debtor corporation in proceedings under Section 77B of the Federal Bankruptcy Act, and subject as such to the jurisdiction of the District Court for the Central Division of the Southern District of California, the court from whose judgment [R. 330-333] this appeal is taken. The petition for leave to file claim for deficiency filed February 19, 1942, the order entered March 10, 1942, granting leave to file such claim, and the objections to allowance filed March 16, 1942, appear at pages 33-38 of the Record; the judgment of denial, except as to $441.17, dated April 24, 1944, appears at pages 330-333 of the Record. Within three months, to-wit on April 24, 1944, the Collector filed notice of appeal to this Court [R. 334], pursuant to the provisions of Section 128(a) of the Judicial Code as amended.

Question Presented.

During the year 1938, the taxpayer corporation operated seven subsidiaries under agreements which provided in part for parent to pay to each subsidiary all operating charges of the latter, including items of depreciation, depletion, and amortization. The taxpayer, which was on the accrual basis, accrued these included items on its books as a credit to the respective subsidiaries for the taxable year, but it never paid any of the amounts and was currently denying liability thereon.

The question is whether the District Court erred in allowing the taxpayer to deduct such amounts as "business expense" within the intendment of Section 23(a) of the Revenue Act of 1938.

Statute Involved.

Revenue Act of 1938, c. 289, 52 Stat. 447:

SEC. 23. DEDUCTION FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—

(1) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including * * * rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * * * * *

(1) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * *

* * * * * * * *

Statement.

The pertinent facts, taken from the original [R. 265-279] and supplemental [R. 325-327] findings of fact made by the District Court upon stipulation of the parties [R. 40-252] and upon oral evidence adduced by the taxpayer [R. 253-261, 320-322], may be stated as follows:

The taxpayer was at all times pertinent a Delaware corporation duly authorized to transact business in the State of California, its principal office being in the City of Los Angeles. [R. 266.] Both the taxpayer and the seven subsidiary corporations here concerned used the accrual system of accounting in making their Federal tax returns. [R. 271.]

In 1929 and 1930, the taxpayer entered into written "operating" agreements with the following five corporations, in all of which corporations it held the controlling interest directly or indirectly [R. 82-83]:

Union Rock Company (Delaware).
Consumers Rock & Gravel Company, Inc. (Delaware).
Reliance Rock Co.
Sunset Rock Products Co., Inc.
Builders Crushed Rock Products Co.

So far as here material the "operating" agreements between the parent and each of these subsidiary corporations were identical. [R. 266-269.] Their pertinent provisions were in substance as follows [R. 267-269]:

(a) A recital that economy and efficiency require the operation of the properties of the owning companies, i.e., the subsidiaries, under one operating organization. [R. 267.]

(b) The parent acquired outright all current personalty of the subsidiary companies. [R. 267.]

(c) The parent assumed all the liabilities of the various subsidiary companies except those based on the purchase of materials, which liabilities the parent could accept or reject at its option. [R. 267.]

(d) Ownership of all fixed assets remained in the subsidiary companies. However, the operating agreement vested "in the operating company for the term hereof the possession and custody" of such assets. [R. 267.]

(e) The parent was authorized to make capital additions to the subsidiaries.[2] [R. 267.]

(f) The parent was required to pay all operating expenses pertaining to the subsidiaries' properties including [R. 267-268]—

> all other operating charges and expenses of the owning companies of every sort and nature, including items of depreciation, depletion, amortization and obsolescence, which items (not involving a cash outlay) shall be credited to the current account of the owning companies and shall be paid to said owning companies as and when provided in Section 14 hereof, and in consideration thereof the operating company shall be and it is hereby authorized to retain for its own use and benefit all net revenues from the operation of said properties.

(g) The parent company was required to return at the conclusion of the agreement the capital properties belonging to the subsidiary corporations [R. 268]—

> in subsantially the same condition as when received by the operating company, appropriate allowance

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[2]This was done from time to time by the parent. [R. 267.]

> being made for any deferred maintenance existing at the effective date of this agreement as compared to that existing when said properties are returned, as well as items of depreciation, depletion, amortization and obsolescence hereafter referred to.

(h) The operating agreement was to remain in effect until terminated by thirty days' written notice by either the subsidiary companies to the parent company or vice versa. [R. 268.]

(i) Upon the termination of the operating agreement, the properties belonging to the subsidiary companies were to be returned to them and [R. 268-269]—

> a financial adjustment shall be made as between the operating company and any such owning company or companies in accordance with the current account of the parties on date of return of said properties and payment shall thereupon be made in accordance therewith.

Immediately upon the execution of the operating agreements hereinbefore referred to "current accounts" were established on the parent corporation's books for each of the five "owning" subsidiary corporations. [R. 269.] At regular monthly intervals beginning at the date of each operating agreement, amounts representing depreciation, depletion and amortization of leaseholds covering both assets originally possessed by each subsidiary corporation, and capital expenditures made on the assets by the parent corporation were determined. These items were set up by the parent on its books as an expense of operation and the credit was actually made to the current account of each subsidiary company for those amounts representing depreciation, depletion and amortization applicable to such assets. The amount of these items appeared on the

debtor's books at the close of each month from the beginning up to and including the month of December, 1938, and at the close of the year 1938 as an unqualified liability to each subsidiary company. [R. 270-271.]

The books of account of each subsidiary company for the same period also showed the amounts representing depreciation, depletion and amortization of leaseholds as a definite and unqualified account receivable and as an asset due from the parent corporation. [R. 271.]

The procedure hereinbefore referred to with respect to the fixed assets owned by the aforementioned five subsidiary corporations covered by these operating agreements was followed precisely with respect to the assets of two other subsidiary companies whose stock was also controlled directly or indirectly by the taxpayer corporation, namely, Union Rock Land Company, a wholly owned subsidiary of Union Rock Company (Delaware) and Atlas Mixed Mortar Company. There was no written operating agreement covering the purchase and use of the properties of the last two named subsidiary corporations, but the treatment accorded these companies and their assets was in all respects identical with that accorded the five subsidiary corporations hereinbefore mentioned. [R. 271-272.] The conduct of the parties indicated that they intended and did enter into a contract covering the ownership and use of properties of the Union Rock Land Company and Atlas Mixed Mortar Company for all purposes here material identical with the terms of the written operating agreements with the five other above-named subsidiary corporations. [R. 272.]

Under date of February 16, 1933, taxpayer parent corporation entered into an agreement with Union Rock Company (Delaware), Consumers Rock & Gravel Company,

Inc. (Delaware), and Reliance Rock Company (Delaware), which agreement was termed a "Modification of Operating Agreement." No similar agreement was ever entered into between the parent and any of the other subsidiary corporations. [R. 272.]

The so-called modification agreement of February 16, 1933, provided in part [R. 273]:

(a) Depreciation (including depletion and amortization) was to be actually credited only upon the termination of the agreement. Its amount was then to be determined by appraisers to be appointed by the contracting parties and was to be based on values and rates determined as of April 1, 1929, and each succeeding year during the life of the operating agreement. [R. 273.]

(b) The term of the operating agreement was to be five years from February 16, 1933, except that [R. 273]—

> operating [parent] company is hereby given the option to extend said operating agreement as hereby modified for a further term of five years upon the same terms and conditions provided that notice of its intention to extend said term is given to each of the owning companies within one year of the date of expiration of the original term in this paragraph specified.

No notice of an extension as hereinbefore referred to was ever given, nor was any agreement made with respect thereto. [R. 273.]

The so-called Modification of Operating Agreement was ignored for all purposes by all the parties thereto. No change of any kind or nature was made by any party to the modification agreement in the accounting procedure theretofore established in the original operating agreement. The parent corporation continued to credit amounts repre-

senting depreciation, depletion and amortization of leaseholds monthly to each subsidiary exactly in accordance with the provisions of the original operating agreements. [R. 273-274.]

When the five year term provided for by the so-called "modification" expired, no appraisers were appointed and no effort was made to determine the debtor's liability for depreciation as provided therein and nothing was ever done with respect thereto. The conduct of the parties to the modification of February 16, 1933, indicated that they intended to and did in fact immediately rescind that modification agreement by complete abandonment of its terms; for the purpose of this proceeding that agreement never became operative. [R. 274.]

On May 24, 1935, petitions for re-organization under Section 77B of the Bankruptcy Act of the parent corporation and two of its subsidiaries, i.e., Union Rock Company (Delaware) and Consumers Rock & Gravel Company, Inc. (Delaware), were filed in this District Court. By appropriate order the parent was temporarily continued in possession of the assets of these corporations. No petition involving receivership, bankruptcy or reorganization was ever filed covering the remaining subsidiary corporations. [R. 274.] Under date of July 2, 1935, the court by appropriate order continued the parent in possession of all of the subsidiaries' properties until further order, including those of the two with which there was no written operating agreement; the court never entered any contrary order. [R. 275.]

The "continue in possession" order of July 2, 1935, in substance authorized the parent to continue existing business and financial agreements, arrangements and relations between the parents and its subsidiaries "to the extent that they may be necessary or advisable in order that the

properties of the debtor and its subsidiary corporations may be operated as nearly as possible under the same policy of management." The order of July 2, 1935, remained in full force and effect at all times pertinent hereto. [R. 275.]

Upon the filing of the petition for re-organization the books of account of the parent and the subsidiaries, Union and Consumers, were closed as of May 24, 1935 were the end of the subsidiaries' fiscal years. New accounts were thereupon set up beginning May 25, 1935. Prior accounting practices were followed exactly with respect to all of the subsidiary corporations. The current accounts of the subsidiary corporations and the parent corporation continued to be credited and debited monthly with amounts representing depreciation, depletion and amortization as heretofore set forth. In so conducting its affairs the parent corporation complied with the order of the District Court dated July 2, heretofore referred to. [R. 275-276.]

In their federal income tax returns for the year 1938, each of the subsidiary corporations took deductions for the amount of depreciation, depletion and amortization which had been credited to the respective accounts by the taxpayer parent corporation. In its federal corporation income and excess-profits tax return for the calendar year 1938 the parent deducted an item entitled "Expenses paid for subsidiaries—$484,214.40." This amount included an item entitled "Expenses paid for subsidiaries" totaling $215,917.64, representing depreciation, depletion and amortization with respect to the properties of the seven subsidiary corporations. These amounts were computed in accordance with the provisions of the various operating agreements. [R. 276.] The United States, the claimant herein, disallowed as deductible expenses to the parent corporation all of the amount of $215,917.64 and adjusted

the parent corporation's taxable income for the year 1938 accordingly; and based upon that adjustment the United States on November 28, 1941, assessed against the parent corporation additional income taxes for the calendar year 1938 in the amount of $25,112.72 plus interest in the amount of $4,071.70. [R. 276.]

The stipulation of facts provided that only questions of law raised by the United States as claimant should be covered in the hearings on the tax claim. It was not conceded by the claimant that if the court should find the parent to be entitled to deduct the items aforementioned, the amounts of such depreciation, depletion and amortization had been correctly computed and determined by the debtor corporation. It was further stipulated that if the court should determine the parent corporation to be entitled to deduct these items, the amount of the deductions should either be agreed to by the parties or absent such agreement determined by the court in a subsequent proceeding. [R. 278-279.]

The District Court's conclusions of law recited [R. 280]:

> The debtor is entitled, in determining its net taxable income for the calendar year 1938, to deduct as expenses of operation the depreciation, depletion and amortization of leaseholds sustained by said seven owning companies heretofore referred to, the properties of which were used and operated during said calendar year 1938 by the debtor herein in connection with its business.

After entry of order [R. 282-285] based on such conclusion and further hearing had upon an issue not material here (except that pursuant to its decision thereon the court adjudged [R. 329] there to be due to the

United States additional income taxes for the year 1938 in the principal sum of $441.17 together with interest), the amount which the debtor in ascertaining its net taxable income for the year 1938 was entitled to deduct with respect to all of these controverted items was determined to be the sum of $78,539.30. [R. 327-328.]

Statements of Points to Be Urged.

The District Court erred in holding that the items here involved were "business expenses" of the taxpayer properly accrued and deductible in the year 1938; the court erred in failing to hold that those items were a contribution by the taxpayer parent corporation to the capital of the respective subsidiary corporations.

Summary of Argument.

The taxpayer parent corporation was not entitled to deduct the amounts of its subsidiaries' 1938 depreciation, depletion, and amortization as "business expense" under Section 23(a)(1) of the Revenue Act of 1938. In the first place, the amounts were not expenses of the parent's business; correctly classified, they were in the nature of contributions by the parent to the capital of the subsidiaries.

But more importantly, even if these items could be classified as business expense, they were not proper deductions of the year 1938. The taxpayer, which used the accrual basis of accounting, was currently denying that it owed its subsidiaries anything under the operation agreements on any count, or asserting that if it had a liability to them, the amount thereof could not be determined. A taxpayer on the accrual basis is never entitled to deduct an item of expense unless and until its liability to pay such item becomes fixed and determined.

ARGUMENT.

The Parent Corporation Was Not Entitled to Deduct the Amounts of Its Subsidiaries' 1938 Depreciation, Depletion, and Amortization, as Business Expense or Otherwise.

It is manifest that since the subsidiary corporations concerned in this case took deduction for depreciation, depletion, and amortization during the taxable year in the amounts here in controversy, the taxpayer corporation which owned the controlling interest in each of the subsidiary corporations, could not itself take deduction therefor; the revenue law does not countenance double deductions in whatever guise. See *Ilfeld Co. v. Hernandez*, 292 U. S. 62. Neither could the parent corporation take deduction therefor irrespective of the subsidiaries' tax-treatment of the items; parent and subsidiaries were separate entities as is evidenced of course by their contracting together, and the operating agreements distinctly show [R. 267] that the parent had no interest in the fixed assets of the subsidiaries beyond the right of custody during the life of the operating contract. The Supreme Court early declared in *Weiss v. Wiener*, 279 U. S. 333, 336, that in order to be entitled to a deduction for depreciation, the taxpayer "must show an interest in the property and a present loss to him." The only interest here and the only present loss which the taxpayer suffered by reason of the depreciation, etc., of the subsidiaries' properties was entirely derivative in character; a loss to a corporation is not a loss for which its stockholders are entitled to deduction. *In re Park's Estate*, 58 F. 2d 965 (C. C. A. 2d), certiorari denied, 287 U. S. 645; *First Nat. Bank in Wichita v. Commissioner*, 46 F. 2d 283 (C. C. A. 10th), certiorari denied, 287 U. S. 636.

But the taxpayer maintains, and this contention was sustained below, that these items were deductible by the parent corporation as business expenses arising out of the operating agreements; specifically, it is the taxpayer's position that for the use of the subsidiaries' properties it agreed to pay rent or compensation measured in part by the amount of depreciation, etc., on the affiliates' assets as specified in the operating contracts. Rent is of course an item of business expense, and deductible as such under Section 23(a)(1), *supra.* But preliminarily we point out, that while the District Court allowed the deductions as "business expense," it did not do so on the theory that they were a measurement of rent. The conclusions of law recite [R. 280]:

> The debtor is entitled, in determining its net taxable income for the calendar year 1938, *to deduct as expenses of operation the depreciation, depletion and amortization of leaseholds sustained by said seven owning companies* heretofore referred to, the properties of which were used and operated during said calendar year 1938 by the debtor herein in connection with its business. (Italics supplied.)

Thus it appears that the court below actually permitted the deduction upon the basis that the depreciation, etc., of the subsidiaries was an allowable "expense of operation" to the parent. We submit that this was clearly an erroneous concept of the ambit of "business expense" as the term is used in the federal revenue law. In our view, these amounts were in the nature of capital contributions from parent to subsidiary; they were not "business expense" within the meaning of Section 23(a)(1) either under the theory upon which the District Court founded its judgment, or upon the taxpayer's thesis that they were rentals.

But if, momentarily, we accept the contention that these items were "business expense" to the taxpayer corporation within the meaning of Section 23(a)(1) under either the court's or the taxpayer's theory, it by no means follows that as such they were proper deductions for the year 1938. The taxpayer and its affiliates used the accrual system of accounting. Had the taxpayer been on the cash basis, it is plain that it would not have been entitled to deduct these amounts because it never paid them; under the accrual system, it could deduct them only if they represented a fixed and determined liability of the taxable year. We propose now to show that they did not.

The taxpayer and two of its subsidiaries were in the midst of reorganization proceedings under Section 77B of the Federal Bankruptcy Act, the petition having been filed in the court below on May 24, 1935, and the court in July of that year having entered an appropriate order continuing the debtor in possession of the properties and authorizing it to carry on all of its existing business and financial agreements, which order remained in force at all times pertinent to this controversy. [R. 274, 275.] A plan of reorganization submitted on March 15, 1937, by the debtor corporation, the taxpayer herein, called for the formation of a new corporation to which the assets of the petitioner corporations would be transferred free of the claims of all except general creditors. For reasons not here pertinent, a bondholder, one Du Bois, among other interested parties, filed objections to the plan, but these were overruled and the court below confirmed the plan on September 8, 1938. Appeal was taken and the order was reversed by this Court on June 19, 1940. In *re Consolidated Rock Products Co.*, 114 F 2d 102. The case was carried to the Supreme Court of the United States where

the order of reversal was affirmed March 3, 1941.[3] *Consolidated Rock Co. v. Du Bois,* 312 U. S. 510.

Throughout this litigation, which involved construction of the original operating agreements under which the taxpayer claims the right to the deduction here in question, and the modification agreement of February, 1933, which it claims and which the court below found [R. 272-274] had never become effective, the debtor corporation wavered between denying liability to its subsidiaries on any count and asserting that if liability existed the amount thereof was impossible of determination. It insisted that at all events the amount of liability to the affiliates by reason of the items of depreciation, depletion, and amortization here concerned,[4] was not then determinable. The taxpayer's brief in the Supreme Court is illuminating; it states at one point (p. 14):

> On the other hand, the preferred stockholders take the position that the agreement of 1933 is neither void nor voidable, that any rights must be determined by the agreement as modified, and that, at most, the rightful claim of Consumers and Union is for an indefinite amount, the payment of which, when determined, Consolidated could properly defer, for the most part, until 1953.

And at another point, it is argued [Br. 16-17]:

> From all of this, how can it be said that the preferred stockholders are unreasonable in denying the existence of any present liability under the operating agreement. Rather it seems that any unreasonable-

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[3]The Government's petition to file this tax claim was filed on February 19, 1942 [R. 33-34], and the claim was denied, except as hereinbefore stated, on April 24, 1944 [R. 333].

[4]And for other years.

> ness lies on the side of the respondent in asserting that a present liability exists.

The taxpayer demonstrated clearly and effectively to the Supreme Court that any claim which the subsidiaries might have was vague and indefinite almost to the vanishing point. Mr. Justice Douglas, who is the author of the opinion in that proceeding, said (pp. 518-520):

> In spite of that finding, the District Court also found that "it would be physically impossible to determine and segregate with any degree of accuracy or fairness properties which originally belonged to the companies separately"; that as a result of unified operation properties of every character "have been commingled and are now in the main held by Consolidated without any way of ascertaining what part, if any thereof, belongs to each or any of the companies separately"; and that, as a consequence, an appraisal "would be of such an indefinite and unsatisfactory nature as to produce further confusion."
>
> The unified operation which resulted in that commingling of assets was pursuant to an operating agreement which Consolidated caused its wholly owned subsidiaries to execute in 1929. Under that agreement the subsidiaries ceased all operating functions and the entire management, operation and financing of the business and properties of the subsidiaries were undertaken by Consolidated. The corporate existence of the subsidiaries, however, was maintained and certain separate accounts were kept. Under this agreement Consolidated undertook, *inter alia,* to pay the subsidiaries the amounts necessary for the interest and sinking fund provisions of the indentures and to credit their current accounts with items of depreciation, depletion, amortization and

> obsolescence. Upon termination of the agreement the properties were to be returned and a final settlement of accounts made, Consolidated meanwhile to retain all net revenues after its obligations thereunder to the subsidiaries had been met.

And again at page 521 the Court's opinion states:

> If as Consolidated maintains the subsidiaries have no present claim against it, the claim can readily be discounted to present worth.

Accordingly, on the taxpayer's own contention respecting these items, as reflected in its brief and in the Supreme Court decision, the alleged items of expense here concerned did not accrue as a deduction in the taxable year 1938. Long since the Supreme Court established the rule that income and expense items "accrue" to a taxpayer only when there arises in him a fixed and unconditional right to receive, or a fixed and unconditional obligation to pay; so long as the right to receive or the obligation to pay is not certain or is contingent, the item has not accrued. The uncertainty must be resolved; the determining event must be awaited. These principles have been acknowledged in cases involving a wide variety of income and expense items; representative examples of such decisions appear in the margin.[5] In fact, after the judgment of

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[5] *United States v. Safety Car Heating Co.*, 297 U. S. 88; *Spring City Co. v. Commissioner*, 292 U. S. 182; *Brown v. Helvering*, 291 U. S. 193; *Burnet v. Huff*, 288 U. S. 156; *North American Oil v. Burnet*, 286 U. S. 417; *Lucas v. Ox Fibre Brush Co.*, 281 U. S. 115; *Lucas v. American Code Co.*, 280 U. S. 445; *Triplex Safety Glass Co. of North America v. Latchum*, 131 F. (2d) 1023 (C. C. A. 3d); *London-Butte Gold M. Co. v. Commissioner*, 116 F. (2d) 478 (C. C. A. 10th); *H. Liebes & Co. v. Commissioner*, 90 F. (2d) 932 (C. C. A. 9th); *Commissioner v. Brooklyn R. S. Corp.*, 79 F. (2d) 833 (C. C. A. 2d); *Umsted v. Commissioner*, 72 F. (2d) 328 (C. C. A. 8th); *Commissioner v. Southeastern Express Co.*, 56 F. (2d) 600 (C. C. A. 5th); *Kentucky & Indiana T. R. Co. v. Commissioner*, 54 F. (2d) 738 (C. C. A. 6th); *Central Power Co. v. United States*, 44 F. Supp. 596 (C. Cls.).

the District Court herein was entered, the Supreme Court had occasion to re-examine and reaffirm this rule with respect to a state tax claim, liability for which the taxpayer was contesting during the tax period for which deduction was sought. *Dixie Pine Co. v. Commissioner*, 320 U. S. 516. In denying the deduction, the Supreme Court declared (p. 519):

> It has long been held that in order truly to reflect the income of a given year, all the events must occur in that year which fix the amount and the fact of the taxpayer's liability for items of indebtedness deducted though not paid; and this cannot be the case where the liability is contingent and is contested by the taxpayer. Here the taxpayer was strenuously contesting liability in the courts and, at the same time, deducting the amount of the tax on the theory that the state's exaction constituted a fixed and certain liability. This it could not do. It must, in the circumstances, await the event of the state court litigation and might claim a deduction only for the taxable year in which its liability for the tax was finally adjudicated.

The Government submits that this language applies with equal force to, and is equally dispositive of, the issue at bar.

In the light of the foregoing, it seems almost a superfluity for the Government now to argue that the items here concerned were not even "business expense," much less deductible as such in the circumstances of this case under the firmly-established principles of federal tax law which we have just discussed. Nevertheless, we point out that similar claims to deduction as "business expense" have been frequently rejected by the courts on the ground that they were in reality akin to capital contributions. It

should be remembered that the taxpayer held controlling interest in the stock of all of these affiliates; it was to its interest that provision be made for eventual replacement of their properties, and it seems evident that this was the purpose of the operating agreement provisions pertaining to depletion, depreciation, etc., suffered by the subsidiaries. Cf. *Majestic Securities Corp. v. Commissioner,* 120 F. 2d 12 (C. C. A. 8th); *Pennsylvania Indemnity Co. v. Commissioner,* 77 F. 2d 92 (C. C. A. 3d).

The Tax Court has consistently classified expenditures analogous to the kind of items involved here as contributions to capital. Thus in *Cambridge Apartment Building Corp. v. Commissioner,* 44 B. T. A. 617, the then Board of Tax Appeals denied that that portion of an assessment made against stockholder-tenants of an apartment building used for the retirement of the assessor's bonds was income to the corporation; the Board held that a capital contribution had been made by the shareholders. Accord: *874 Park Avenue Corp. v. Commissioner,* 23 B. T. A. 400; *Paducah & Illinois Railroad Co. v. Commissioner,* 2 B. T. A. 1001. And cf. *Gatlin v. Commissioner,* 34 B. T. A. 50; *Bank of California, National Assn. v. Commissioner,* 30 B. T. A. 556; *Burns v. Commissioner,* 11 B. T. A. 524; *Paxton v. Commissioner,* 7 B. T. A. 92; *Lutz v. Commissioner,* 2 B. T. A. 484.

In *Interstate Transit Lines v. Commissioner,* 130 F. 2d 136 (C. C. A. 8th), the taxpayer corporation sought to take a loss deduction for the operating deficit of its wholly-owned subsidiary, having contracted with the subsidiary *inter alia* to underwrite the latter's operating expenses. The court denied the deduction, saying (p. 140):

> We also agree with the Board that the payment by the petitioner of the deficit of the subsidiary was a

> capital expenditure, not an ordinary and necessary expense of the petitioner's business.
>
> The conditions which distinguish a capital investment from an ordinary and necessary business expense in cases where a stockholder contributes something to his corporation have been settled, not by unanimity of decision, but by clear weight of authority. [Cases cited in the margin omitted.] If the contribution (1) is a benefit to or has value to the stockholder and (2) becomes an asset of the corporation when transferred to it, the stockholder increases his capital investment in the corporation, and the payment is not a deductible business expense. Whether such payment was made by reason of a contractual obligation or was merely a voluntary act does not affect the result.[6]

And while in the *Interstate Transit case*, it was the subsidiary who was "operating" on behalf of the parent, whereas here it was the parent who was "operating" the subsidiaries, the principle of law remains precisely the same. In each case the stockholder was making a contribution to the permanent capital structure of the corporation.

The items here involved were not "business expense" of the taxpayer corporation within the meaning of Section 23(a)(1). But even if they were in that category, they were nevertheless non-deductible in the year 1938, for they were not fixed and determined liabilities of that tax period.

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[6]This decision was affirmed in the Supreme Court. *Interstate Transit Lines v. Commissioner,* 319 U. S. 590. That Court did not find it necessary to decide, however, whether the item was properly classifiable as a capital contribution it held that since the subsidiary's operations were not a part of the parent taxpayer's business, the former's deficit was not a deductible loss to the latter.

Conclusion.

The judgment of the District Court should be reversed except as to $441.17, which amount the court determined to be due to the Government upon other grounds.

Respectfully submitted,

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